**DEPARTMENT OF STATE REVENUE**
**LETTER OF FINDINGS NUMBER 04-20050076P**
**TAX ADMINISTRATION—NEGLIGENCE PENALTIES FOR THE USE TAX**
**REPORTING PERIODS COVERING CALENDAR YEARS 2001-02**

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## ISSUE

### I. Tax Administration—Negligence Penalty—Audit Deficiency (Use Tax)

Authority: IC §§ 6-2.5-3-4(a)(1) and -5 (1998), 6-8.1-1-1, -5-1(b), -10-2.1 and 10-7 (2004); *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359 (1941); *Laptops Etc. Corp. v. Dist. of Columbia (In re Laptops Etc. Corp.)*, 164 B.R. 506 (Bankr. D. Md. 1993); *Ind. Dep't of State Revenue v. Trump Ind. Inc.*, 814 N.E.2d 1017 (Ind. 2004); *State Bd. of Tax Comm'rs v. New Castle Lodge # 147, L.O.O.M.*, 765 N.E.2d 1257 (Ind. 2002); *Morton Bldgs., Inc. v. Ind. Dep't of State Revenue (Morton Bldgs. VII)*, 819 N.E.2d 913 (Ind. Tax Ct. 2004), *review denied* 831 N.E.2d 744 (Ind. 2005) (table); *Hoogenboom-Nofziger v. State Bd. of Tax Comm'rs*, 715 N.E.2d 1018 (Ind. Tax Ct. 1999); *USAir, Inc. v. Ind. Dep't of State Revenue* (*USAir II*), 623 N.E.2d 466 (Ind. Tax Ct. 1993); *Morton Bldgs., Inc. v. Comm'r of Revenue (Morton Bldgs. V)*, 683 N.E.2d 720 (Mass. App. Ct. 1997); *Olin Corp. v. Dir. of Revenue*, 945 S.W.2d 442 (Mo. 1997) (*en banc*); *House of Lloyd, Inc. v. Dir. of Revenue*, 884 S.W.2d 271 (Mo. 1994) (*en banc*); *Great Am. Airways v. Nev. State Tax Comm'n*, 705 P.2d 654 (Nev. 1985); *Datascope Corp. v. Tax Appeals Trib.*, 608 N.Y.S.2d 562 (App. Div. 1994); 45 IAC §§ 2.2-3-4 (2001) and 15-11-2(b) and (c) (2004); 68 Am. Jur. 2d *Sales and Use Taxes* § 168 (2004)

The taxpayer protests the proposed assessment of negligence penalties for its incurring an audit deficiency of use tax.

## STATEMENT OF FACTS

The taxpayer is a publicly traded corporation that operates a chain of restaurants. At present it has locations in the District of Columbia and 29 states, including one restaurant in Indiana, according to the Locations webpage of the taxpayer's website. It is headquartered, and was organized in 1982, in another state, but the Indiana Secretary of State granted the taxpayer authority to conduct business here in late October of 1999. The taxpayer opened its Indiana restaurant in 2000 and began filing gross retail (sales)/use tax returns (Form ST-103) with this Department beginning with the June 2000 reporting period.

The Audit Division of this Department conducted a field audit of the taxpayer's liability for state

gross retail (sales), state use and county food and beverage taxes for calendar years 2001-03 (hereinafter "the audit period"). The auditor increased the taxpayer's use tax liability for calendar years 2001-02. He arrived at the adjustments giving rise to that increase by conducting a census audit of the taxpayer's capital asset transactions and a sample audit of its other taxable purchases. The latter category, which is in issue in this protest, consisted of purchases of kitchen, dining room and bar utensils, china and glassware, and various supplies (hereinafter collectively "smallware"). All of the assessed smallware was bought from one vendor that did not collect sales tax from the taxpayer. The audit Summary does not indicate that the taxpayer's Indiana restaurant had any other suppliers of these kinds of items during the audit period.

The use tax audit resulted in proposed assessments totaling in the high four-figure range for the two adjusted years. The auditor cited in the Summary to 45 IAC § 2.2-3-4 (2001) (current version at *id.* (2004)) as authority for the assessments. The auditor also proposed, and the Audit Division approved, including a negligence penalty in the Notices of Proposed Assessment for both years. The taxpayer paid the parts of the assessments equal to the base tax and accrued interest and timely filed a written protest, but only of the negligence penalties. The Department will provide additional facts as needed.

## DISCUSSION

### A. APPLICABLE PENALTY LAW

IC § 6-8.1-10-2.1 (2004) is the statute that authorizes the Department to impose a penalty for any negligence of a taxpayer in failing to comply with the tax laws that the Department administers. IC § 6-8.1-10-2.1(a)(3) states that "(a) [i]f a person:… (3) [i]ncurs, upon examination by the department, a deficiency that is due to negligence; … the person is subject to a penalty." *Id.* Title 45 IAC § 15-11-2(b) (2004) defines "negligence" in relevant part as follows:

> (b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. *Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence.*

*Id.* (Emphasis added.) "[L]isted tax laws" refers to the definition of the term "listed taxes" found in IC § 6-8.1-1-1 (2004). The listed taxes are all of the tax laws for which the General Assembly has explicitly made the Department responsible. They include the Gross Retail and Use Tax Act of 1963, IC article 6-2.5 (1998) (current version at *id.* (2004)) ("GRUTA").

"If a person subject to the penalty imposed under this section [IC § 6-8.1-10-2.1] can show that the failure to…pay the deficiency determined by the department was *due to reasonable cause* and not due to willful neglect, the department shall waive the penalty." IC § 6-8.1-10-2.1(d) (emphasis added.). The implementing regulation restates this requirement as requiring the taxpayer to show that the failure to discharge its tax duties "was due to reasonable cause and not due to negligence." 45 IAC § 15-11-2(c). This subsection of the regulation goes on to state:

> In order to establish reasonable cause, the taxpayer must demonstrate that it exercised *ordinary business care and prudence* in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
>
> …
>
> (2) judicial precedents set by Indiana courts; [and]
>
> (3) judicial precedents established in jurisdictions outside Indiana[.]
>
> …
>
> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

*Id.* (Emphasis added.) The taxpayer "must make an affirmative showing of all facts alleged as a reasonable cause for [its] failure to … pay the deficiency[.]" IC § 6-8.1-10-2.1(e). The evidentiary showing the taxpayer must make under IC § 6-8.1-10-2.1(d) and (e) and 45 IAC § 15-11-2(c) is consistent with IC § 6-8.1-5-1(b), which places the burden of proof in all protests on the person against whom a proposed assessment is made to prove that it is wrong.

IC § 6-8.1-10-7 imposes the only other limits, monetary ones, on the Department's authority to assess and enforce a penalty under IC § 6-8.1-10-2.1. That statute provides:

> Notwithstanding the various penalty provisions of [IC] chapter [6-8.1-10], the maximum total penalty that may be assessed against a person under sections 2.1 through 5 of this chapter [i.e., IC §§ 6-8.1-10-2.1 to -5, which all use percentage formulas to calculate the respective penalties they impose] is one hundred percent (100%) of the unpaid tax and *the minimum penalty, if any, that may be assessed under those sections is five dollars ($ 5).*

*Id.* (Emphasis added).

## B. TAXPAYER'S ARGUMENT

The taxpayer argues that the purchases giving rise to the deficiency were from only one vendor that had did not collect sales tax from the taxpayer and that those purchases [.1] represented only a small percentage of its total purchases for the audit period. The taxpayer is essentially contending that the Department should waive the negligence penalties because the percentage of purchases on which it failed to pay use tax is, in the taxpayer's view, *de minimis*.

## C. ANALYSIS

As noted at the end of Subpart A, IC § 6-8.1-10-7 sets the maximum and minimum amounts of percentage-based penalties, including the negligence penalty, the Department may assess; the

minimum is five dollars ($5). However, once the Department has assessed a negligence penalty over that minimum, as it did here, IC § 6-8.1-10-2.1(d) and (e) govern the Department's ability to waive that penalty. There is nothing in either of those subsections that even authorizes the Department to waive a negligence penalty on the ground that the amount of unpaid tax is *de minimis*, much less anything setting out an amount, or a formula to determine an amount, of unpaid tax that the Department could treat as being *de minimis*. Nor does IC § 6-8.1-5-1(a), the subsection requiring the Department to make a proposed assessment of tax it reasonably believes was not properly reported, set any minimum figure of unpaid tax below which the Department is excused from doing so. Had the General Assembly wanted to set a floor amount of unpaid tax below which it would deem the taxpayer not liable for any such tax as a matter of law (as distinguished from granting the Department administrative discretion to make such a determination), it easily could have said so.

The only ground on which IC § 6-8.1-10-2.1(d) requires the Department to waive a negligence penalty, once assessed, is "reasonable cause[.]" *Id.* The legislature's use of this term necessarily implies that the determinative factor for the Department in deciding whether to waive a negligence penalty is the cause of, not the amount of unpaid tax resulting from, the compliance failure in question. The only material reference to a number concerning the negligence penalties IC § 6-8.1-10-2.1(a) imposes is to the amount of unpaid, underpaid, unreported or underreported taxes. The only use for that figure that IC § 6-8.1-10-2.1 mentions is to compute the negligence penalty; subsection (b) uses that amount as the multiplicand to which the Department applies the ten percent multiplier to determine the amount of the subsection (a) penalty. *See* IC § 6-8.1-10-2.1(b) (setting out the computation formulae). The size of this multiplicand, standing alone, is irrelevant to answering the questions of why and how it came into being, and more precisely to answering the question of whether or not the failure out of which it arose was due to the taxpayer's negligence.

The taxpayer has not made any alternative argument, much less submitted any evidence in support of such an argument, as to why its "failure to…pay the [part of the] deficiency [on taxable purchases] determined by the department was due to reasonable cause and not due to willful neglect[.]" IC § 6-8.1-10-2.1(d). Nor has the taxpayer made any argument as to why it had reasonable cause to incur the part of the deficiency attributable to its capital asset purchases. Indiana law is settled that this state's taxation hearing officers, and by extension the state-level taxing authorities of which they are agents, "do not have the duty to make a taxpayer's case." *Hoogenboom-Nofziger v. State Bd. of Tax Comm'rs*, 715 N.E.2d 1018, 1024 (Ind. Tax Ct. 1999), *cited with approval in State Bd. of Tax Comm'rs v. New Castle Lodge # 147, L.O.O.M.*, 765 N.E.2d 1257, 1264 (Ind. 2002). The Tax Court stated its rationale for this rule later in *Hoogenboom-Nofziger* as follows:

> [T]o allow [a taxpayer] to prevail after it made such a cursory showing at the administrative level would result in a tremendous workload increase for [the Department and] the State Board [now the Indiana Board of Tax Review], … administrative agenc[ies] that already bear[ ] … difficult burden[s] in administering this State's [listed and] property tax system[s]. If taxpayers could make a de minimis showing and then force [the Department or] the State Board to support its decisions with detailed factual findings, the [Indiana taxing authorities]

> would be overwhelmed with cases such as this one. This would be patently unfair to other taxpayers who do make detailed presentations to the [taxing authorities] because resolution of their appeals would necessarily be delayed.

715 N.E.2d at 1024-25. The Department therefore summarily denies the taxpayer's protest to the extent that the negligence penalties derive from the parts of its use tax deficiency for each year assessed on taxable capital asset transactions. The only issue left is thus whether, without regard to the alleged *de minimis* character of the taxpayer's deficiency, the taxpayer had reasonable cause for incurring the parts of that deficiency assessed on its other taxable purchases. The Department will base its finding on this question solely on relevant information in the audit file, its other records on the taxpayer, the public domain (including other official records), any reasonable inferences from that information, and any applicable authorities that cursory research revealed.

The Department notes that at this writing the taxpayer has been in business for over 23 years and, as previously noted, has restaurants in 29 other state-level taxing jurisdictions nationwide. It is reasonable to infer that the taxpayer would not have survived, let alone have built up its business to its present size, had the taxpayer crippled itself by repeatedly incurring substantial tax deficiencies. It is thus also reasonable to infer that by the time the taxpayer started doing business in Indiana in 1999-2000, it had learned the nationwide general legal view as to the place and role of the use tax in state and local tax systems and the circumstance under which liability for that tax accrues to the jurisdiction in which the property becomes located. As pointedly expressed in 1997 by the Appeals Court of Massachusetts, where the taxpayer has done business since 1995, "*[t]he use tax* is complementary to the sales tax and *bites when the sales tax does not.*" *Morton Bldgs., Inc. v. Comm'r of Revenue (Morton Bldgs. V)*, 683 N.E.2d 720, 722 (Mass. App. Ct. 1997) (emphases added), *paraphrased and followed in Morton Bldgs., Inc. v. Ind. Dep't of State Revenue (Morton Bldgs. VII)*, 819 N.E.2d 913, 915 (Ind. Tax Ct. 2004), *review denied* 831 N.E.2d 744 (Ind. 2005) (table). In other words, the taxpayer should have learned by the time it started doing business in Indiana that if it did not pay sales tax on a non-exempt purchase of tangible personal property later placed in a jurisdiction that had sales and use taxes, the taxpayer would owe that jurisdiction use tax.

This rule follows from the well-settled general law in this country on the purpose and function of a use tax. "It [has long been] one of the well-known functions of the integrated use and sales tax to remove the buyers' temptation to place their orders in other states in the effort *to escape payment of the tax on local sales*." *Nelson v. Sears, Roebuck & Co.*, 312 U.S. 359, 363 (1941) (internal quotation marks omitted) (emphasis added). In addition to the United States Supreme Court, at least ten courts sitting in jurisdictions other than Indiana have reported opinions discussing this subject and taking the same view. Their consensus, summarized in a secondary source, is that "[t]he use tax is correlative of, and is complementary and supplemental to, the sales tax, *one of its principal purposes being to prevent the evasion of the sales tax.*" 68 Am. Jur. 2d *Sales and Use Taxes* § 168 (2004) (footnote omitted) (emphasis added). Four of the opinions this last source cites, *id.* n.96, like *Morton Buildings V*, interpreted the use tax laws of other jurisdictions where the taxpayer did business, and were issued, before the taxpayer began doing business in Indiana in 1999-2000. *Laptops Etc. Corp. v. Dist. of Columbia (In re Laptops Etc. Corp.)*, 164 B.R. 506, 517 (Bankr. D. Md. 1993) (sustaining debtor-in-possession's

objection to District of Columbia's use tax proof of claim and discussing the general distinction and relationship between sales and use taxes); *Great Am. Airways v. Nev. State Tax Comm'n*, 705 P.2d 654, 657 (Nev. 1985), and *Datascope Corp. v. Tax Appeals Trib.*, 608 N.Y.S.2d 562, 564 (App. Div. 1994). *See also Olin Corp. v. Dir. of Revenue*, 945 S.W.2d 442, 443 (Mo. 1997) (*en banc*) ("Missouri sales and use taxes are complementary tax schemes that 'are designed to assure that purchases of tangible personal property for valuable consideration by a Missouri purchaser receive identical tax treatment no matter what the geographic location of the seller[,]' (quoting *House of Lloyd, Inc. v. Dir. of Revenue*, 884 S.W.2d 271, 273 (Mo. 1994) (*en banc*))). There was thus ample non-Indiana authority giving the taxpayer constructive notice it must pay use tax to any jurisdiction with sales and use taxes on any non-exempt tangible personal property placed there if no sales tax was paid when purchased.

*Morton Buildings VII*, cited above, makes it clear that Indiana is in the judicial mainstream regarding the function and role of the use tax. The Indiana Supreme Court settled the law and removed any doubt that might have lingered on this point less than three months before the Indiana Tax Court issued *Morton Buildings VII*. *See Ind. Dep't of State Revenue v. Trump Ind. Inc.*, 814 N.E.2d 1017, 1019 (Ind. 2004). Admittedly, neither opinion was issued until after the close of the taxpayer's audit period. However, it did have the benefit of the first reported Indiana opinion, issued well before that period began, that made the same point:

> Like most states, Indiana has complementary sales and use taxes. *See* IND. CODE 6-2.5-3-4(a)[(1)] [(1988) (audit period and current versions at *id.* (1998) and (2004), respectively) (exempting the storage, use and consumption of tangible personal property in Indiana from use tax if Indiana sales tax was paid when that property was acquired)]. … *The complementary formulation exists to ensure non-exempt retail transactions that escape sales tax liability are nonetheless taxed.*

*USAir, Inc. v. Ind. Dep't of State Revenue* (*USAir II*), 623 N.E.2d 466, 468-69 (Ind. Tax Ct. 1993) (citation omitted) (emphasis added), citing, among other authorities, *Great American Airways*, above, 705 P.2d at 657-58 n.5. Title 45 IAC § 2.2-3-4, which was in effect when the Tax Court issued *USAir II* and on which the present taxpayer's auditor relied, is to the same effect. "Tangible personal property, purchased in Indiana, or elsewhere in a retail transaction, and stored, used, or otherwise consumed in Indiana is subject to Indiana use tax for such property, unless the Indiana state gross retail tax has been collected at the point of purchase." *Id.* *But cf.* IC § 6-2.5-3-5 (1998) (current version at *id.* (2004)) (granting a credit against use tax for any sales, purchase or use tax paid to another state-level taxing jurisdiction when the tangible personal property was acquired).

The rule that a taxpayer must pay use tax if it did not pay sales tax on a non-exempt transaction thus was and is no different in Indiana than in any other jurisdiction with sales and use taxes in which the taxpayer had done business. It was incumbent upon the taxpayer, before starting business in this state, to become familiar with the Indiana use tax authorities then in effect, of which it was and is held to have constructive knowledge in any case. *See* 45 IAC § 15-11-2(b) ("Ignorance of the listed tax laws, rules and/or regulations is treated as negligence."). Since, as the foregoing discussion shows, there were only a few such authorities, it should not have been very burdensome for the taxpayer to research them.

However, even if it did not do so, given the taxpayer's past experience complying with the use tax laws of other jurisdictions where it had operated, it should have known it would probably be liable for use tax if it did not pay sales tax to its Indiana restaurant's vendors. It is all but impossible for the Department to believe the taxpayer did not actually know of, or had not paid use tax elsewhere pursuant to, this general rule of purchaser liability before the audit period. As mentioned earlier, the taxpayer's business would not have lasted as long or become as big and geographically wide-ranging as it has if the taxpayer repeatedly had been assessed substantial tax deficiencies. In particular, it is unlikely that the untaxed transactions in issue here were the first of their kind in the taxpayer's history, given the duration and size of its nationwide business.

The taxpayer purchased smallware for its only Indiana restaurant from a vendor that, for all that appears in the Summary (the only evidence the Department has, since the taxpayer submitted none), was the only such vendor that restaurant had during calendar years 2000-01. That vendor failed to collect and remit sales taxes on those transactions. It is no defense to the proposed negligence penalty assessments to say, as the taxpayer implies in its protest letter, that the vendor should have done so. The vendor's failure to collect those taxes should have been a red flag alerting the taxpayer to self-assess, report and remit use tax on those purchases. The taxpayer's legal liabilities for those taxes should have been clear. The taxpayer nevertheless failed to recognize, report and pay those liabilities, thereby incurring the present audit deficiencies. It is highly improbable (although not impossible), that the taxpayer's failures were due to ignorance of Indiana use tax law. More probably, they were due to carelessness. Either way, however, those failures constituted "negligence" as defined in 45 IAC § 15-11-2(b). They are not evidence of an "exercise[ ] [of] ordinary business care and prudence[,]" 45 IAC § 15-11-2(b), and therefore are not "reasonable cause" under IC 6-8.1-10-2.1(d) and (e) to waive the negligence penalties for the taxpayer's incurring those deficiencies.

## FINDING

The taxpayer's protest is denied.

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